ITEM 6. SELECTED FINANCIAL DATA.

The selected financial data set forth below for the years ended December 31, 1996, 1997, 1998, 1999 and 2000 were derived from our audited financial statements and those of our predecessors. The data presented below should be read in conjunction with Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements and notes thereto included in Item 8 "Financial Statements and Supplementary Data."

	Year Ended December 31,				
	1996	1997	1998	1999	2000
	(IN THOUSANDS, EXCEPT PER SHARE DATA)				
STATEMENT OF OPERATIONS DATA:					
Revenue	$ 205	$ 3,417	$ 22,425	$ 64,313	$ 209,195
Operating expenses:					
Network operating costs:					
Non-cash stock option compensation	19	1,110	566	2,387	2,731
Other network operating costs	1,361	5,482	27,699	81,678	169,593
Selling, general and administrative:					
Non-cash stock option compensation	221	12,760	6,514	27,446	31,840
Other selling, general and administrative	2,216	12,176	34,171	84,434	162,275
Depreciation and amortization	287	2,506	9,257	29,077	76,129
Total operating expenses	4,104	34,034	78,207	225,022	442,568
Loss from operations	(3,899)	(30,617)	(55,782)	(160,709)	(233,373)
Other expense (a)	-	-	-	(4,297)	-
Interest income	-	513	8,818	8,701	11,784
Interest expense (b)	(596)	(2,582)	(29,789)	(69,411)	(136,393)
Net loss before cumulative effect of change in accounting principle	(4,495)	(32,686)	(76,753)	(225,716)	(357,982)
Cumulative effect of change in accounting principle (c)	-	-	-	-	(1,705)
Net loss	(4,495)	(32,686)	(76,753)	(225,716)	(359,687)
Dividends and accretion on redeemable preferred stock	-	(8,904)	(18,285)	(81,633)	(94,440)
Net loss applicable to common shareholders	$ (4,495)	$ (41,590)	$ (95,038)	$(307,349)	$ (454,127)
Net loss per common share before cumulative effect of change in accounting principle	$ (7.49)	$ (64.93)	$ (114.42)	$ (360.88)	$ (529.22)
Cumulative effect of change in accounting principle (c)	-	-	-	-	(1.99)
Net loss per common share	$ (7.49)	$ (64.93)	$ (114.42)	$ (360.88)	$ (531.21)
Proforma amounts assuming the change in accounting principle was applied retroactively:					
Net loss applicable to common shareholders	$ (4,495)	$ (41,746)	$ (95,424)	$(309,054)	$ (452,422)
Net loss per common share	$ (7.49)	$ (65.17)	$ (114.88)	$ (362.88)	$ (529.22)
Weighted average number of common shares outstanding	600	641	831	852	855
OTHER FINANCIAL DATA:					
Capital expenditures (d)	$ 9,111	$ 61,146	$ 161,803	$ 440,733	$ 457,651
Adjusted EBITDA(e)	(3,372)	(14,241)	(39,445)	(101,799)	(122,673)
EBITDA(e)	(3,612)	(28,111)	(46,525)	(135,929)	(157,244)
Cash used in operating activities	(2,687)	(8,676)	(33,573)	(98,293)	(146,448)
Cash used in investing activities	(10,174)	(62,992)	(180,198)	(277,078)	(488,952)
Cash provided by financing activities	14,314	85,734	219,399	440,156	659,411

	Year Ended December 31,				
	1996	1997	1998	1999	2000

	(IN THOUSANDS)				
BALANCE SHEET DATA:					
Cash and cash equivalents....................	$ 1,487	$ 15,553	$ 21,181	$ 85,966	$ 109,977
Restricted investments.......................	-	-	-	88,571	100,056
Working capital..............................	(2,345)	3,672	(1,391)	(57,007)	(63,116)
Networks, property and equipment, net........	12,347	71,371	224,890	639,324	1,021,684
Total assets.................................	16,715	95,943	311,310	886,040	1,331,275
Long-term notes payable......................	12,330	61,277	41,414	235,000	728,173
Other long-term debt.........................	-	-	267,811	576,137	615,181
Redeemable preferred stock...................	-	35,925	52,033	203,790	472,765
Redeemable common stock and warrants.........	-	11,726	22,979	46,680	62,380
Total nonredeemable equity (deficiency)......	389	(26,673)	(104,353)	(384,413)	(819,471)

(a) During the second quarter of 1999, we recorded a $4.3 million charge to other expense in connection with an unfavorable arbitration award. The net amount due under the terms of the award was paid in full in June 1999.

(b) Excludes capitalized interest of (i) $103,000 for 1996, (ii) $854,000 for 1997, (iii) $5.1 million for 1998, (iv) $6.6 million for 1999 and (v) $10.4 million for 2000. During the construction of our networks, the interest costs related to construction expenditures are capitalized.

(c) In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), REVENUE RECOGNITION IN FINANCIAL STATEMENTS. SAB 101 provides additional guidance in applying generally accepted accounting principles to revenue recognition in financial statements. Through December 31, 1999, we recognized installation revenue upon completion of the installation. Effective January 1, 2000, in accordance with the provisions of SAB 101, we are recognizing installation revenue over the average contract period. The cumulative effect of this change in accounting principle resulted in a charge of approximately $1.7 million which was recorded in the quarter ended March 31, 2000. For the year ended December 31, 2000, the net effect of adopting this change in accounting principle was a deferral of the recognition of $3.0 million of revenue, which increased net loss for the year by $3.56 per share. Revenue for the year ended December 31, 2000 includes $1.7 million of revenues that, prior to the accounting change, had been recognized through December 31, 1999.

(d) The figure for 1997 includes $2.0 million related to the acquisition of a network.

(e) Adjusted EBITDA consists of earnings (loss) before net interest, income taxes, depreciation and amortization charges, stock option compensation expense (a non-cash charge), other expense and cumulative effect of change in accounting principle. EBITDA consists of earnings (loss) before all of the foregoing items except stock option compensation expense and other expense. These items are provided because they are measures commonly used in the telecommunications industry. They are presented to enhance an understanding of our operating results and they are not intended to represent cash flow or results of operations in accordance with generally accepted accounting principles. Adjusted EBITDA and EBITDA are not calculated under generally accepted accounting principles and are not necessarily comparable to similarly titled measures of other companies.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

YOU SHOULD READ THE FOLLOWING DISCUSSION AND ANALYSIS TOGETHER WITH OUR FINANCIAL STATEMENTS, INCLUDING THE NOTES AND THE OTHER FINANCIAL INFORMATION APPEARING ELSEWHERE IN THIS REPORT. DUE TO OUR LIMITED OPERATING HISTORY, STARTUP NATURE AND RAPID GROWTH, PERIOD-TO-PERIOD COMPARISONS OF FINANCIAL DATA ARE NOT NECESSARILY INDICATIVE, AND YOU SHOULD NOT RELY UPON THEM AS AN INDICATOR OF OUR FUTURE PERFORMANCE. THE FOLLOWING DISCUSSION INCLUDES FORWARD-LOOKING STATEMENTS. SEE "--CERTAIN FACTORS WHICH MAY AFFECT OUR FUTURE RESULTS".

OVERVIEW

We are a rapidly growing fiber-based integrated communications provider offering data, voice and Internet infrastructure services. We offer these services to businesses, governments and institutional end-users, Internet service providers, long distance carriers and wireless service providers. Our business has two distinct components: serving communications-intensive customers in Tier III markets, and providing data services on a nationwide basis.

We provide a full suite of broadband communications services in 37 Tier III markets, which we define as markets with a population between 100,000 and 750,000. We own and operate robust fiber-based networks and switching equipment in all of our Tier III markets, which are predominantly located in the South, Southeast, Midwest and Mid-Atlantic United States. We will continue to expand in our existing Tier III markets because we believe that these markets have attractive growth attributes and are typically less competitive than larger markets. Our customers in these markets include: AT&T, Boeing, City of Augusta, Columbia Hospital, NASA, Pillsbury, State of Wisconsin, Texas A&M University and Wal-Mart.

We also provide nationwide data services under long-term guaranteed revenue contracts. Under these contracts, we provide local Internet access infrastructure and other enhanced data services and will be providing Voice over Internet Protocol beginning in the second half of 2001. Currently, we have contracts representing approximately $280 million in annualized revenues in approximately 140 markets. We expect these markets to be operational by the second quarter of 2001. The Internet infrastructure we are deploying includes the latest technology platforms from Cisco and Nortel, which we believe will result in a cost-effective and technologically superior solution for our customers.

TIER III MARKETS. We have installed fiber-based SONET networks, or self- healing synchronous optical networks, using a Class 5 switch in all of our 37 markets. Our fiber optic networks are initially designed and built to reach approximately 80% of the business access lines in each of our markets, typically requiring a local fiber loop of about 30 to 40 miles.

As our switches have become operational, our operating margins have improved meaningfully. Our operating margins have also improved due to increased on-network revenues relative to resale revenues. On-network revenues are revenues earned from services provided on our network, including by direct connection to our switch, unbundled network element or dedicated line. Resale revenues are generated when traffic is carried completely on the incumbent local exchange carriers' facilities. On-network revenues have increased from approximately 37% of our revenues for the year ended December 31, 1998 to approximately 95% of our revenues for the year ended December 31, 2000.

NATIONWIDE DATA PLATFORM. We currently provide Internet access infrastructure using remote access servers manufactured by Cisco and Nortel which we are deploying in our 41 supernodes, including ten in our existing Tier III markets. Supernodes are concentration points for high-speed connectivity to the Internet.

Under the terms of our existing guaranteed revenue contracts, we provide the routing and ancillary equipment for each supernode, as well as data transport service from the incumbent local exchange carrier to our supernode location. Our customers pay us a fixed price per port and compensate us for certain expenses, including space, power and transport, that we may incur above an agreed level. This structure provides highly predictable revenues and costs over the life of each contract, currently ranging from 42 to 51 months. These contracts began generating revenues during the third quarter of 2000. Revenues will continue to increase as the contracts are phased in through the third quarter of 2001. These contracts started providing positive margins beginning with the commencement of revenues in the third quarter of 2000.

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We purchased approximately $134.4 million of equipment (the "KMC Funding V Equipment") relating to these contracts during the first quarter of

2000. We sold this equipment to General Electric Credit Corporation and CIT Lending Services Corporation, and leased it back from them, during the second quarter of 2000. We purchased an additional $168.6 million of equipment (the "KMC Funding Equipment") relating to these contracts during the second quarter of 2000 and signed an agreement in November 2000 with Dresdner Kleinwort Benson North American Leasing, Inc. to finance this equipment by means of a 48 month term loan. In March 2001, we entered into two financing transactions (the "KMC Funding V Monetization" and the "KMC Funding Monetization," respectively) and repaid the remaining balance on this term loan and exercised our purchase option on the KMC Funding V Equipment under the operating lease. See "--Liquidity and Capital Resources" below for a detailed description of these transactions.

The table below provides selected key operational and financial data on a consolidated basis as of the following dates:

	Quarter Ended				
	December 31, 1999	March 31, 2000	June 30, 2000	September 30, 2000	December 31, 2000
Tier III operational markets....	34	35	35	35	37
Route miles....................	1,475	1,724	1,989	2,178	2,285
Fiber miles....................	94,119	110,335	122,376	134,952	140,988
Collocations...................	81	111	124	125	134
Customers......................	6,060	7,305	8,513	9,990	11,602
Total buildings connected.......	4,108	5,615	7,088	9,085	9,745
Total lines in service..........	318,031	480,079	767,992	1,865,390	2,284,375
On-network revenues(a)(b).......	87%	88%	93%	96%	97%
Resale revenues(a)(c)...........	13%	12%	7%	4%	3%

(a) As a percentage of total revenues.

(b) On-network revenues are revenues earned from services provided on our network, including by direct connection to our switch, unbundled network element or dedicated line.

(c) Resale revenues are generated when traffic is carried completely on the incumbent local exchange carriers' facilities.

REVENUE. Our revenue is derived from the sale of local switched services, long distance services, Centrex-type services, private line services, special access services and Internet access infrastructure. In prior years, a significant portion of our revenue was derived from the resale of switched services. We have transitioned the majority of our customers on-network and as a result the portion of our revenue related to the resale of switched services has decreased from 63% of total revenue for the year ended 1998 to 5% of total revenue for the year ended 2000.

RECIPROCAL COMPENSATION. We recognized reciprocal compensation revenue of approximately $9.7 million, or 15.1% of our total revenue for 1999 and approximately $18.2 million or 8.7% of our total revenue for the year ended December 31, 2000. In May 2000, we reached a resolution of our claims for payment of certain reciprocal compensation charges, previously disputed by BellSouth Corporation. Under the agreement, BellSouth made a one-time payment that resolved all amounts billed through March 31, 2000. In addition, we agreed with BellSouth on future rates for reciprocal compensation, setting new contractual terms for payment. Our prior agreement with BellSouth provided for a rate of $.009 per minute of use for reciprocal compensation. Under the terms of the new agreement, the rates for reciprocal compensation which will apply to all local traffic, including ISP-bound traffic, will decrease over time. The reduction will be phased in over a three-year period beginning with a rate of $.002 per minute of use until March 31, 2001, $.00175 per minute of use from April 1, 2001 through March 31, 2002 and $.0015 per minute of use from April 1, 2002 through March 31, 2003.

In March 2001, we filed a formal complaint against Southwestern Bell Telephone Company with the Kansas Corporation Commission seeking payment of past due reciprocal compensation for calls to Internet service providers. We cannot predict the outcome of this proceeding.

We are currently pursuing resolution of this issue with other incumbent local exchange carriers. Our goal is to reach mutually acceptable terms for both outstanding and future reciprocal compensation amounts for all traffic. We cannot assure you that we will reach new agreements with these carriers on favorable terms

As of December 31, 2000, we have provided reserves which we believe are sufficient to cover any amounts which may not be collected, but we cannot assure you that this will be the case. Our management will continue to consider the circumstances surrounding this dispute periodically in determining whether additional reserves against unpaid balances are warranted.

OPERATING EXPENSES. Our principal operating expenses consist of network operating costs, selling, general and administrative expenses, stock option compensation expense and depreciation and amortization. Network operating costs include charges from termination and unbundled network element charges; charges from incumbent local exchange carriers for resale services; charges from long distance carriers for resale of long distance services; salaries and benefits associated with network operations, billing and information services and customer care personnel; franchise fees and other costs. Network operating costs also include a percentage of both our intrastate and interstate revenues which we pay as universal service fund charges. National data platform operating expenses include space, power, transport, maintenance, staffing, sales, general and administrative and rental expenses under our operating lease agreements. Certain of these costs are passed through to the carrier customer which allows us to limit our maintenance and servicing costs to predetermined levels, and to receive additional revenues for any costs incurred in excess of such predetermined levels. Selling, general and administrative expenses consist of sales personnel and support costs, corporate and finance personnel and support costs and legal and accounting expenses. Depreciation and amortization includes charges related to plant, property and equipment and amortization of intangible assets, including franchise acquisition costs. Depreciation and amortization expense will increase as we place additional equipment into service expanding our existing networks.

INTEREST EXPENSE. Interest expense includes interest charges on our senior notes, senior discount notes, our senior secured credit facilities and our Internet infrastructure equipment financings. Interest expense also includes amortization of deferred financing costs.

RESULTS OF OPERATIONS

YEAR ENDED DECEMBER 31, 2000 COMPARED TO YEAR ENDED DECEMBER 31, 1999

REVENUE. Revenue increased 225% from $64.3 million for 1999 to $209.2 million for 2000. This increase is attributable to the fact that our Tier III Market business derived revenues from 37 markets during 2000 compared to 23 markets during most of 1999 as well to the fact that our Nationwide Data Platform business began to generate revenues for the first time in the third quarter of 2000. In addition, each of our Tier III markets that generated revenues during 1999 generated increased revenues during 2000.

On-network local switched services, long distance services, Centrex-type services, private line services, special access services and Internet access infrastructure revenues ("On-network revenues") represented 95% of total revenue in 2000, compared to 69% of total revenue in 1999; while revenue derived from the resale of switched services ("Resale revenue") represented 5% and 31% of total revenue, respectively, during those periods. On-network revenues include revenues derived from services provided through direct connections to our own networks, services provided by means of unbundled network elements leased from the incumbent local exchange carrier and services provided by dedicated line. In addition, we recognized reciprocal compensation revenue of approximately $18.2 million or 8.7% of our total revenue for the year 2000.

NETWORK OPERATING COSTS. Network operating costs, excluding non-cash stock compensation expense, increased 108% from $81.7 million for 1999 to $169.6 million for 2000. This increase of $87.9 million is due primarily to the increase in the number of markets in which we operated in 2000 as compared to 1999 combined with expenses related to the startup of our Nationwide Data Platform business in the third quarter of 2000. The components of this increase

are $48.3 million in direct costs associated with our Tier III Market and Nationwide Data Platform businesses which provide on-network services, including leasing unbundled network elements, and resale services, $18.0 million in personnel costs, $7.3 million in network support services, $5.4 million in consulting and professional services costs, $2.7 million in telecommunications costs and $6.2 million in other direct operating costs.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses, excluding non-cash stock compensation expense, increased 92% from $84.4 million for 1999 to $162.3 million in 2000. This increase of $77.9 million is due primarily to the increase in the number of markets in which we operated in 2000 as compared to 1999 as well as to the fact that our Nationwide Data Platform business commenced operations for the first time in the third quarter of 2000. The components of this increase are $38.0 million in personnel costs, $11.0 million in professional costs, $5.7 million in facility costs, $3.2 million in telecommunications costs and $2.4 million in travel related costs, as well as increases in other marketing and general and administrative costs aggregating approximately $17.6 million, including amounts related to our arrangement with KNT.

STOCK OPTION COMPENSATION EXPENSE. Stock option compensation expense, a non-cash charge, in aggregate increased 16% from $29.8 million in 1999 to $34.6 million for 2000. This increase is due primarily to an increase in the estimated fair value of our common stock, as well as the grant of additional option awards during 2000.

DEPRECIATION AND AMORTIZATION. Depreciation and amortization expense increased 162% from $29.1 million for 1999 to $76.1 million for 2000. This increase is due primarily to depreciation expense associated with the greater number of networks in commercial operation during 2000.

INTEREST INCOME. Interest income increased 36% from $8.7 million in 1999 to $11.8 million in 2000. The increase is due primarily to larger average cash, cash equivalent and restricted cash balances during 2000 as compared to 1999, as well as receiving interest at a higher average rate.

INTEREST EXPENSE. Interest expense increased 97% from $69.4 million in 1999 to $136.4 million in 2000. Of this increase, $49.2 million is related to higher borrowings under our senior secured credit facilities, $15.1 million is attributable to the fact that our $275 million of 13 1/2% senior notes, issued in May 1999, were outstanding throughout all of 2000, $4.9 million is due to accretion and amortization of financing costs on our senior discount notes and $1.6 million is due to our Nationwide Data Platform business. The individual increases above were offset by a $3.8 million increase in capitalized interest related to network construction projects which increased from $6.6 million during 1999 to $10.4 million during 2000.

NET LOSS BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE. For the reasons stated above, net loss before cumulative effect of change in accounting principle increased from $225.7 million for 1999 to $358.0 million for 2000.

YEAR ENDED DECEMBER 31, 1999 COMPARED TO YEAR ENDED DECEMBER 31, 1998

REVENUE. Revenue increased 187% from $22.4 million for 1998 to $64.3 million for 1999. This increase is primarily attributable to revenues derived from 23 markets we serviced during 1999, as compared to 1998 when we derived revenues from only 8 markets during the entire year, and began to derive revenues from 14 additional markets during the fourth quarter of 1998. In addition, each of our markets that generated revenues during 1998 generated increased revenues during 1999.

During 1998 and 1999, we recognized revenue which we believed was due to us from incumbent local exchange carriers for terminating local traffic of Internet service providers. We determined to recognize this revenue because we concluded, based upon all of the facts and circumstances known to us at the time, including numerous state public service commission and state and federal court decisions upholding competitive local exchange carriers' entitlement to reciprocal compensation for such calls, that realization of those amounts was reasonably assured. On October 13, 1999, however, the Louisiana Public Service Commission ruled that local traffic to Internet service providers in Louisiana is not eligible for reciprocal compensation. As a result of that ruling, we determined that we could no longer conclude that realization of amounts attributable to termination of local calls to Internet service providers in Louisiana was reasonably assured. Accordingly, we recorded an adjustment to

reduce revenue in the third quarter of 1999, which reversed all reciprocal revenue recognized related to Internet service provider traffic in Louisiana for the entire year of 1998 and the first nine months of 1999. The adjustment amounted to $4.4 million, of which $1.1 million relates to the year ended December 31, 1998 and $3.3 million relates to the nine months ended September 30, 1999.

Although incumbent local exchange carriers, such as BellSouth (prior to our May 2000 settlement with them), have generally withheld payments of amounts due for reciprocal compensation to competitive local exchange carriers like us for calls to Internet service providers and disputed the entitlement of competitive local exchange carriers to reciprocal compensation for such calls in jurisdictions other than Louisiana as well, we have determined to continue to recognize amounts due to us for reciprocal compensation for such calls in jurisdictions other than Louisiana and South Carolina (which is the only other jurisdiction in which we currently operate that has adopted a similar position) because we have concluded, based upon all of the facts and circumstances, including numerous state public service commissions and state and federal court decisions upholding competitive local exchange carriers' entitlement to reciprocal compensation for such calls, that realization of such amounts is reasonably assured.

Revenue for 1998 and 1999 included $14.2 million and $19.7 million, respectively, derived from resale services and an aggregate of $8.2 million and $44.6 million (including, after giving effect to the third quarter 1999 $4.4 million adjustment for Louisiana, $9.7 million of revenue related to reciprocal compensation during 1999), respectively, of revenue derived from on-network services. Resale services represented 63% of revenue in 1998 and 31% of revenue in 1999.

NETWORK OPERATING COSTS. Network operating costs, excluding non-cash stock compensation expense, increased 195% from $27.7 million in 1998 to $81.7 million in 1999. This increase of $54.0 million was due primarily to the increase in the number of markets in which we operated in 1999. The components of this increase are $27.7 million in direct costs associated with providing on-network services, including leasing unbundled network elements, and resale services, $14.3 million in personnel costs, $4.2 million in network support services, $5.1 million in consulting and professional services costs, $600,000 in facility costs, $900,000 in travel costs and $1.2 million in telecommunications and other direct operating costs.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES. Selling, general and administrative expenses, excluding non-cash stock compensation expense, increased 147% from $34.2 million in 1998 to $84.4 million in 1999. This increase of approximately $50.2 million resulted primarily from increases of $25.4 million in personnel costs, $5.1 million in professional costs, $3.4 million in travel related costs, as well as increases in other marketing and general and administrative costs aggregating approximately $16.3 million. These increases were due primarily to the greater number of networks in commercial operation during 1999.

STOCK OPTION COMPENSATION EXPENSE. Stock option compensation expense, a non-cash charge, increased 320% from an aggregate of $7.1 million for 1998 to $29.8 million for 1999. This increase primarily resulted from an increase in the estimated fair value of our common stock, as well as the grant of additional option awards during 1999.

DEPRECIATION AND AMORTIZATION. Depreciation and amortization expense increased from $9.3 million for 1998 to $29.1 million for 1999, primarily as a result of depreciation expense associated with the greater number of networks in commercial operation during 1999.

OTHER EXPENSE. During the second quarter of 1999, we recorded a $4.3 million charge to other expense in connection with an unfavorable arbitration award. The net amount due under the terms of the award was paid in full in June 1999.

INTEREST INCOME. Interest income remained consistent from $8.8 million in 1998 to $8.7 million in 1999.

INTEREST EXPENSE. Interest expense increased from $29.8 million in 1998 to $69.4 million in 1999. Of this increase, $23.3 million is attributable to the fact that our $275 million of 13 1/2% senior notes were issued in May 1999, $10.9 million is attributable to higher borrowings under our senior secured credit facility and $6.9 million is attributable to increased accretion year over year on our senior discount notes. The individual increases above were

offset by a $1.5 million increase in capitalized interest related to network construction projects from $5.1 million during 1998 to $6.6 million during 1999.

NET LOSS. For the reasons stated above, net loss increased from $76.8 million for 1998 to $225.7 million for 1999.

STOCK COMPENSATION PLAN

During 1996 and 1997, one of our principal operating subsidiaries granted options to purchase shares of its common stock pursuant to its 1996 Stock Plan. On June 26, 1998, our board of directors adopted the 1998 Stock Purchase and Option Plan for Key Employees of KMC Telecom Holdings, Inc. and Affiliates which authorizes the grant of options to purchase shares of our common stock and replaced our 1996 Stock Plan. During the third quarter of 1998, we replaced the options to purchase shares of common stock previously granted under the 1996 Stock Plan, with options to purchase shares of our common stock granted under the 1998 Stock Plan. We also granted new options to some additional employees. Upon cancellation of the outstanding options under the 1996 Stock Plan, we reversed all compensation expense previously recorded with respect to those options. Additionally, to the extent the fair value of our common stock exceeded the exercise price of the options granted under the 1998 Stock Plan, we recognized compensation expense related to such options to the extent vested. The net effect of the cancellation of the options outstanding under the 1996 Stock Plan and the grant of options under the 1998 Stock Plan resulted in a credit to compensation expense of approximately $600,000 in 1998.

Some of the provisions in the stock option awards granted under the 1998 Stock Plan will necessitate that the awards be treated as variable stock compensation awards pursuant to Accounting Principles Board Opinion No. 25. Accordingly, compensation expense will be charged or credited periodically through the date of exercise or cancellation of such stock options, based on changes in the value of our stock as well as the vesting schedule of such options. These compensation charges or credits are non-cash in nature, but could have a material effect on our future reported net income (loss).

LIQUIDITY AND CAPITAL RESOURCES

We have incurred significant operating and net losses as a result of the development and operation of our networks. We expect that such losses will continue as we emphasize the development, construction and expansion of our networks and build our customer base. As a result, we do not expect there to be any cash provided by operations in the near future. We will also need to fund the expansion of our networks and our capital expenditures related to our nationwide data platform business. We have financed our operating losses and capital expenditures with equity invested by our founders, preferred stock placements, credit facility borrowings, equipment loans, operating leases, monetizations and our 12 1/2% senior discount notes and 13 1/2% senior notes.

During the first quarter of 2000, we amended, restated and combined our prior senior secured credit facility and our prior Lucent facility in a single $700.0 million facility. Under this amended senior secured credit facility, our subsidiaries which own our 37 existing networks are permitted to borrow up to an aggregate of $700.0 million, subject to certain conditions, for the purchase of fiber optic cable, switches and other telecommunications equipment and, once certain financial conditions are met, for working capital and other general corporate purposes.

During the quarter ended June 30, 2000, our subsidiary, KMC Telecom, IV, Inc., closed a new senior secured term loan from Lucent Technologies Inc. Proceeds from this loan were to be used to purchase or install Lucent products. This loan agreement was subsequently terminated by both parties and the equipment purchased under it was returned to Lucent.

In July 2000, we issued shares of Series G Convertible Preferred Stock to Lucent Technologies, Dresdner Kleinwort Benson Private Equity Partners, CIT Lending Services, Nassau Capital Partners and Harold N. Kamine, our Chairman, for aggregate gross proceeds of $182.5 million (See Note 7, "Redeemable and Nonredeemable Equity-SERIES G PREFERRED STOCK," of the Notes to Consolidated Financial Statements included in Item 8 of this Report on Form 10-K). The Series G Convertible Preferred Stock has an aggregate liquidation preference of $182.5 million and an annual cumulative dividend equal to 7% of the liquidation

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preference. Payment of the unpaid dividends is triggered by an initial public offering in which we receive aggregate gross proceeds of at least $80.0 million or a merger, consolidation or sale of substantially all of our assets. In such event, we may elect to pay these dividends with additional shares of our common stock.

In March 2001, we entered into a financing transaction (see Note 18, "Subsequent Events-KMC FUNDING MONETIZATION," of the Notes to Consolidated Financial Statements included in Item 8 of this Report on Form 10-K) that resulted in us receiving unrestricted gross proceeds of $325.0 from a secured loan. The KMC Funding Monetization is secured by the future cash flows from our Nationwide Data Platform business contract that was entered into in June 2000 (see Note 9, "Significant Contracts and Customers," of the Notes to Consolidated Financial Statements included in Item 8 of this Report on Form 10-K). The KMC Funding Monetization requires that the principal and interest be paid on a monthly basis upon receipt of the monthly proceeds from the related contract. We retain the right to receive the remaining cash flows from this contract which are expected to be approximately 25% of the monthly cash flows (from which on-going operational expenses must be paid). We realized net proceeds of approximately $145.5 million after using the proceeds to pay off the 48 month term loan we obtained pursuant to our November 2000 agreement with Dresdner Kleinwort Benson North American Leasing, Inc. to finance our acquisition of the KMC Funding Equipment (see Note 5, "Long-Term Debt - KMC FUNDING INTERNET INFRASTRUCTURE EQUIPMENT FINANCING," of the Notes to Consolidated Financial Statements included in Item 8 of this Report on Form 10-K), as well as to pay any financing fees and expenses related to the monetization.

In March 2001, we entered into a financing transaction (see Note 18, "Subsequent Events-KMC FUNDING V MONETIZATION," of the Notes to Consolidated Financial Statements included in Item 8 of this Report on Form 10-K) that resulted in us receiving unrestricted gross proceeds of $225.4 million from a secured loan. The KMC Funding V Monetization is secured by the future cash flows from our Nationwide Data Platform business contract that was entered into in March 2000 (see Note 9, "Significant Contracts and Customers," of the Notes to

Consolidated Financial Statements included in Item 8 of this Report on Form 10-K). The KMC Funding V Monetization requires that the principal and interest be paid on a monthly basis upon receipt of the monthly proceeds from the related contract. We retain the right to receive the remaining cash flows from this contract which are expected to be approximately 25% of the monthly cash flows (from which on-going operational expenses must be paid). We realized net proceeds of approximately $125.5 million after using the proceeds to exercise our purchase option with respect to the KMC Funding V Equipment which we were leasing from GECC and CIT Lending Services Corporation under an operating lease, as well as to pay any financing fees and expenses related to the monetization.

In March 2001, we purchased approximately $65.0 million of Voice over Internet Protocol equipment in association with entering into an agreement with Qwest (see Note 18, "Subsequent Events - VOIP EQUIPMENT CONTRACT," of the Notes to Consolidated Financial Statements included in Item 8 of this Report on Form 10-K). We expect to enter into a financing transaction to fund the cost of this equipment; however, we can give no assurances that we will be able to obtain such financing.

In April 2001, we further amended our amended senior secured credit facility. The aggregate amount of the facility remains at $700.0 million and funds are available under it for the same purposes. The primary changes effected by the amendment were (i) changes to certain of the financial covenants to reflect changes in the Company's business since the amended senior secured credit facility was entered into and to permit continued compliance with those covenants by the borrowers in accordance with its revised business plan, (ii) to conform the repayment schedules of both term loans and the revolving loan, (iii) to require the borrowers to make an aggregate of $100 million in prepayments on the loans in accordance with an agreed schedule, (iv) to require the Company to use a portion of the proceeds of future equity issuances in excess of a cumulative $200.0 million to make additional prepayments on the loans, (v) to require the Company to use agreed upon portions of the proceeds from certain sales of assets to make additional prepayments on the loans, (vi) to require the Company to use agreed upon portions of the excess cash flows from its Nationwide Data Platform business to make additional capital contributions to the borrowers, (vii) to require the Company to restructure those of its subsidiaries involved in its Nationwide Data Platform business under a single subsidiary holding company, the shares of which will be pledged as additional collateral for KMC Holding's obligations under its guaranty of the amended senior secured credit facility, and (viii) to increase the interest rate. In connection with the amendment, the lenders also waived failures by the borrowers to comply with certain of the prior financial covenants as of March 31, 2001, and the Company made aggregate capital contributions to the borrowers of $200.0 million. In

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addition, the collateral for KMC Holdings' guaranty of the facility was expanded to include substantially all of the assets of KMC Holdings. For a more detailed discussion of this amendment see Note 18, "Subsequent Events - AMENDMENT TO AMENDED SENIOR SECURED CREDIT FACILITY," included in Item 8 of this Report on Form 10-K.

As of March 30, 2001, we had $656.2 million and $550.4 million of indebtedness outstanding under the amended senior secured credit facility and the combined KMC Funding V Monetization and KMC Funding Monetization, respectively. Subject to certain conditions, as of that date we had an additional $43.8 million in borrowing capacity available under the amended senior secured facility. The KMC Funding V Monetization and KMC Funding Monetization were both fully drawn at that date.

Net cash provided by financing activities from borrowings and equity issuances was $659.4 million and our net cash used in operating and investing activities was $635.4 million for the year ended December 31, 2000.

We made capital expenditures of $161.8 million in 1998, $440.7 million in 1999, and $457.7 million in 2000. Of the total capital expenditures for 2000, $280.7 million was related to the Tier III Markets business segment and $177.0 million was for the Nationwide Data Platform business segment. As of March 30, 2001, we had outstanding purchase commitments aggregating approximately $32.2

million related to the purchase of fiber optic cable and telecommunications equipment under our agreements with certain suppliers and service providers. We currently anticipate capital expenditures to be approximately $120.0 million for the Tier III Markets business for 2001. It is our intention that capital expenditures for the Nationwide Data Platform business will be financed separately and therefore will not affect our current liquidity position. The majority of the Tier III Market expenditures are expected to be made for network expansion to facilitate the offering of our services. We expect to continue to incur operating losses while we expand our business and build our customer base. Actual capital expenditures and operating losses will depend on numerous factors, including the nature of future expansion and acquisition opportunities and factors beyond our control, including economic conditions, competition, regulatory developments and the availability of capital.

We believe that our cash and borrowings available under the amended senior secured credit facility will be sufficient to meet our liquidity needs to fund operating losses and capital expenditure requirements for all of our 37 Tier III markets, our current Nationwide Data Platform contracts and other existing commitments into the second quarter of 2002.

However, in the event that our plans change, the assumptions upon which our plans are based prove inaccurate, we expand or accelerate our business plan or we determine to consummate acquisitions, the foregoing sources of funds may prove insufficient and we may be required to seek additional financing sooner than we currently expect. Additional sources of financing may include public or private equity or debt financings, leases and other financing arrangements. We can give no assurance that additional financing will be available to us or, if available, that it can be obtained on a timely basis and on acceptable terms.

We believe that the present market prices of our 12 1/2% senior discount notes and our 13 1/2% senior notes represent an opportunity for us to reduce our long-term debt. Accordingly, our subsidiaries have recently made, and may in the future make, purchases of senior discount notes and/or senior notes in the open market from time to time at then prevailing market prices. Certain of our officers and directors may also make purchases for their own account. We may utilize a portion of our unrestricted cash to pay for any purchases of senior discount notes or senior notes that we may make.

CERTAIN FACTORS WHICH MAY AFFECT OUR FUTURE RESULTS

WE HAVE A LIMITED OPERATING HISTORY AND HAVE INCURRED SIGNIFICANT NEGATIVE CASH FLOW FROM OPERATIONS AND SIGNIFICANT NEGATIVE EBITDA SINCE INCEPTION

We commenced material operations in 1996 and, as a result, we have a limited operating history and limited revenues. We have only recently completed the process of building many of our networks. Accordingly, you will have limited historical financial information upon which to base your evaluation of our business. Our prospects for financial and operational success must be considered in light of the risks, expenses and difficulties frequently encountered by companies in their early stage of development.

In connection with the expansion of our networks we have incurred and expect to continue to incur significant negative cash flow from operations while we expand our business and build our customer base. Our negative cash flow and negative EBITDA have increased in each of the last five years. Our operating losses and cash used by operations will increase as a result of the continuation of our expansion strategy.

For the year ended December 31, 2000, we had revenues of $209.2 million, negative cash flow from operations of $146.4 million and negative EBITDA of $157.2 million.

We might not achieve or sustain profitability or at any time have sufficient resources to meet our capital expenditure and working capital requirements. We will need to significantly increase our revenues and cash flows to meet our debt service obligations.

OUR FUTURE GROWTH MAY REQUIRE SUBSTANTIAL ADDITIONAL CAPITAL

Our current plans for expansion may require substantial additional cash from outside sources. We currently anticipate that our capital expenditures for 2001 will be approximately $120.0 million for the Tier III Markets business. It is our intention that capital expenditures for the Nationwide Data Platform business will be financed separately and therefore will not affect our current liquidity position. We will also have substantial net losses to fund and our substantial cash requirements will continue into the foreseeable future.

Additional sources of financing may include:

- public or private equity or debt financings,
- capitalized leases, and
- other financing arrangements.

Additional financing may not be available to us on acceptable terms, within the limitations contained in the documents relating to our indebtedness, or at all. Failure to obtain such additional financing could result in the delay or abandonment of some or all of our development and expansion plans and expenditures.

WE HAVE A SUBSTANTIAL AMOUNT OF INDEBTEDNESS, SIGNIFICANT DEBT SERVICE REQUIREMENTS AND REFINANCING RISKS

As of March 31, 2001, we had approximately $1.8 billion of indebtedness outstanding. In addition, until February 15, 2003, our senior discount notes accrete in value instead of paying cash interest. At March 31, 2001, the carrying value of the notes was $350.8 million, which will accrete to a principal amount of $460.8 million as of February 15, 2003. Subsequently, we will be required to make semi-annual cash interest payments on these notes. Our substantial indebtedness could have important consequences. For example, it could:

- limit our ability to obtain additional financing in the future,
- require us to dedicate a substantial portion of our cash flow from operations to make payments on our indebtedness, thereby reducing the funds available to us for other purposes, including working capital and capital expenditures,
- limit our flexibility in planning for, or reacting to changes in, our business or the industry in which we operate,
- make us more highly leveraged than many, if not all, of our competitors, which could place us at a competitive disadvantage relative to our competitors that are less leveraged, and
- increase our vulnerability in the event of a downturn in our business.

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The documents under which our long-term debt was issued contain a number of significant covenants. These covenants limit, among other things, our ability to:

- borrow additional money,
- create liens,
- engage in sale-leaseback transactions,
- pay dividends,

- make investments,
- sell assets,
- issue capital stock,
- redeem capital stock,
- merge or consolidate, and
- enter into transactions with our stockholders and affiliates.

The limitations contained in the documents under which our long-term debt was issued are subject to a number of important qualifications and exceptions. In particular, while the indentures applicable to our senior discount notes and our senior notes restrict our ability to incur additional indebtedness, they do permit us to incur an unlimited amount of purchase money indebtedness. If we incur new indebtedness, the related risks that we and our subsidiaries now face could intensify.

Under our credit facilities, certain of our subsidiaries are required to meet a number of financial tests at the end of each quarter. In addition, these subsidiaries are required to prepay at least $100 million of indebtedness under those credit facilities prior to May 1, 2002. Failure to comply with these tests or to make the required prepayments could limit their ability to make further borrowings, or could result in a default under our credit facilities, allowing the lenders to accelerate the maturity of the loans made thereunder. Our subsidiaries might not be able to comply with these covenants in the future.

If we fail to meet our obligations under the documents governing our indebtedness there could be a default on our indebtedness which would permit the holders of substantially all of our indebtedness to accelerate the maturity thereof.

In connection with the build-out of our networks and expansion of our services, we recorded negative EBITDA and our earnings were insufficient to cover fixed charges for 1998, 1999 and 2000. After giving effect to the increase in interest expense resulting from the establishment of the forty-eight month term loan with Dresdner Kleinwort Benson North American Leasing Inc. which we entered into in November 2000 to purchase the KMC VI Equipment (and which was later repaid with a portion of the proceeds from the KMC Funding Monetization) and the termination of the KMC Telecom IV credit facility as if they occurred on January 1, 2000, our earnings would have been insufficient to cover fixed charges by $370.1 million for the year ended December 31, 2000. We might not be able to improve our earnings before fixed charges or EBITDA. If we do not, we will not be able to meet our debt service obligations.

BECAUSE WE ARE A HOLDING COMPANY, WE WILL BE RELIANT ON FUNDS FROM OUR SUBSIDIARIES TO REPAY OUR INDEBTEDNESS AND OUR SUBSIDIARIES' CREDITORS MAY HAVE PRIORITY ON THOSE FUNDS

We are a holding company whose sole material asset is the common stock of our subsidiaries. In connection with the amended senior secured credit facility, we have reaffirmed the pledge of all of the common stock of our operating subsidiaries that own our 37 existing networks to the lenders under the amended senior secured credit facility. These operating subsidiaries, which currently own substantially all of our operating assets related to our Tier III Markets business, are directly liable to the lenders under the amended senior secured credit facility. In addition, under a recent amendment to the amended senior secured credit facility, we will be required to pledge to the lenders all of the common stock of a subsidiary holding company which we will organize to hold all of the common stock of the operating subsidiaries through which we conduct our National Data Platform business.

We must rely upon dividends and other payments from our operating subsidiaries to generate the funds necessary to meet our obligations, including the payment of principal and interest on the notes. These subsidiaries are legally distinct from us and have no obligation to pay amounts due by us. The ability of our operating subsidiaries to make such payments to us will be subject to, among other things, the availability of funds, the terms of each operating subsidiary's indebtedness and applicable state laws. In particular, the terms of the operating subsidiaries' credit facilities prohibit them from paying dividends and principal and interest on intercompany borrowings unless, among other things, they are in compliance with certain financial covenants. Accordingly, we cannot assure you that we will be able to obtain any funds from our operating subsidiaries.

Claims of creditors of our subsidiaries, including trade creditors, will generally have priority as to the assets of such subsidiaries over the claims of the Company and the holders of our indebtedness and capital stock. We have unconditionally guaranteed the repayment of the amended senior secured credit facility.

THERE ARE RISKS IN CONNECTION WITH OUR NATIONWIDE DATA PLATFORM BUSINESS

We have entered into a number of guaranteed revenue contracts with carrier customers whereby we, as the local service provider, will provide data telecommunications services to these companies for approximately 42 to 51 months. At the present time we have commitments under these agreements to provide more than one million ports.

To date, we have principally financed the capital cost of the equipment associated with the provision of this service. We are wholly dependent upon payment of fees under agreements with the carrier customers in order to fund the required financing.

We do not have an option to renew or extend these agreements. In addition, given the rapid change in technology in the telecommunications industry, the equipment may be obsolete at the end of the term.

Currently, more than 96% of the ports comprising our nationwide data platform are subject to our contracts with Qwest. Any failure by Qwest to make the contracted payments would have a material adverse effect on our business.

OUR INDUSTRY IS EXTREMELY COMPETITIVE AND MANY OF OUR COMPETITORS HAVE GREATER RESOURCES THAN WE HAVE

The telecommunications industry is extremely competitive, particularly with respect to price and service. We face competition in all of our markets, primarily from incumbent local exchange carriers. Generally, our incumbent local exchange carrier competitor is one of the regional Bell operating companies. The incumbent local exchange carriers:

- have long-standing relationships with their customers,
- have financial, technical and marketing resources substantially greater than we have,
- have the potential to fund competitive services with revenues from a variety of businesses, and

- currently benefit from a number of existing regulations that favor these carriers.

We do not believe that Tier III markets can profitably support more than two facilities-based competitors to the incumbent local exchange carrier. In several of our markets we face competition from two or more facilities-based competitive local exchange carriers. After establishing and funding a network in a given market, the marginal cost of carrying an additional call is negligible. Accordingly, in Tier III markets where there are three or more facilities-based competitive local exchange carriers, we expect substantial price competition. We believe that such markets may be unprofitable for one or more operators.

Potential competitors in our markets include:

- microwave carriers,
- wireless telecommunications providers,
- cable television companies, utilities, regional Bell operating companies seeking to operate outside their current local service areas,
- independent telephone companies, and
- large long distance carriers, such as AT&T and MCI WorldCom, which have begun to offer integrated local and long distance telecommunications services.

Industry consolidation and the formation of strategic alliances within the telecommunications industry, as well as the development of new technologies, could also give rise to significant new competitors for us.

A large portion of our Nationwide Data Platform business will be conducted in larger Tier I and Tier II markets. We expect that our primary competitors in this business will be both incumbent local exchange carriers and other competitive local exchange carriers. Because the regional Bell operating companies and other incumbent local exchange carriers tend to focus their efforts on Tier I and Tier II markets, they will have a significantly greater local presence in these markets. In addition, due to the larger size of the markets, there are a greater number of facilities-based competitive local exchange carriers competing for data business in these markets than we usually face in Tier III markets. For this reason, we generally will not enter these markets to offer nationwide data platform services unless we have a pre-existing agreement with a significant customer justifying our presence in the market.

One of the primary purposes of the Telecommunications Act of 1996 is to promote competition, particularly in local markets. Recent regulatory initiatives allow competitive local exchange carriers like us to interconnect with incumbent local exchange carrier facilities. This provides increased business opportunities for us. However, these regulatory initiatives have been accompanied by increased pricing flexibility for, and relaxation of regulatory oversight of, the incumbent local exchange carriers. If the incumbent local exchange carriers engage in increased volume and discount pricing practices or charge us increased fees for interconnection to their networks, or if the incumbent local exchange carriers delay implementation of our interconnection to their networks, our business may be adversely affected.

To the extent we interconnect with and use incumbent local exchange carrier networks to serve our customers, we are dependent upon their technology and capabilities. The Telecommunications Act imposes interconnection obligations on incumbent local exchange carriers, but we cannot assure you that we will be able to obtain the interconnections we require at desirable rates, terms and conditions. In the event that we experience difficulties in obtaining appropriate and reasonably priced service from the incumbent local exchange carriers, our ability to serve our customers would be impaired.

Both the long distance and data transmission businesses are extremely competitive. Prices in both businesses have declined significantly in recent years and are expected to continue to decline. Our long distance services face competition from large carriers such as AT&T, MCI WorldCom and Sprint. We will

rely on other carriers to provide transmission and termination for our long distance traffic and therefore will be dependent on such carriers.

Although we expect to experience declining prices and increasing price competition, we might not be able to achieve or maintain adequate market share or revenue, or compete effectively, in any of our markets.

INCUMBENT LOCAL EXCHANGE CARRIERS HAVE DISPUTED THE ENTITLEMENT OF COMPETITIVE LOCAL EXCHANGE CARRIERS TO RECIPROCAL COMPENSATION FOR CERTAIN CALLS TO INTERNET SERVICE PROVIDERS

In most states in which we provide services, our arrangements with the incumbent local exchange carriers provide that every time a customer of an incumbent local exchange carrier connects to an Internet service provider that is one of our customers, we are entitled to receive payment from the incumbent local exchange carrier. This payment is called "reciprocal compensation." The incumbent local exchange carriers have objected to making reciprocal compensation payments and are seeking to have this changed by legislation, regulation and litigation. The incumbent local exchange carriers have threatened to withhold, and in many cases have withheld, reciprocal compensation for such calls. We recognized reciprocal compensation revenue of approximately $18.2 million or 8.7% of our revenue, related to these calls for the year ended December 31, 2000. As of December 31, 2000, the receivable related to these calls was approximately $7.2 million.

In May 2000, we reached a resolution of our claims for payment of certain reciprocal compensation charges previously disputed by BellSouth Corporation. Under the agreement, BellSouth made a one-time payment that resolved all amounts billed through March 31, 2000. In addition, we agreed with BellSouth on future rates for reciprocal compensation, setting new contractual terms for payment. Our prior agreement with BellSouth provided for a rate of $.009 per minute of use for reciprocal compensation. Under the terms of the new agreement, the rates for reciprocal compensation which will apply to all local traffic, including Internet service provider-bound traffic, will decrease over time. The reduction will be phased in over a three year period beginning with a rate of $.002 per minute of use until March 31, 2001, $.00175 per minute of use from April 1, 2001 through March 31, 2002 and $.0015 per minute of use from April 1, 2002 through March 31, 2003.

In March 2001, we filed a formal complaint against Southwestern Bell Telephone Company with the Kansas Corporation Commission seeking payment of past due reciprocal compensation for calls to Internet service providers. We cannot predict the outcome of this proceeding.

We are currently pursuing resolution of this issue with other incumbent local exchange carriers. Our goal is to reach mutually acceptable terms for both outstanding and future reciprocal compensation amounts for all traffic. We cannot assure you that we will reach new agreements with these carriers on favorable terms; nor can we assure you that changes in legislation or regulation will not adversely affect our ability to collect reciprocal compensation.

WE RELY ON INCUMBENT LOCAL EXCHANGE CARRIERS FOR INTERCONNECTION AND PROVISIONING

Although the incumbent local exchange carriers are legally required to "unbundle" their network into discrete elements and permit us to purchase only the network elements we need to originate and terminate our traffic, thereby decreasing operating expenses, we cannot assure you that this unbundling will be timely or result in favorable prices. We cannot service a new customer unless the incumbent local exchange carrier sends a technician to physically alter its network (known as provisioning). We have experienced delays in provisioning unbundled network elements from incumbent local exchange carriers in the past and these delays have hampered our revenue growth. These delays may continue to occur.

In January 1999, the Supreme Court overturned the Federal Communications Commission's rules regarding which network elements must be unbundled by the incumbent local exchange carriers, and remanded to the Federal Communications Commission the question of which network elements are "necessary" to competing carriers like us. The Supreme Court also remanded several issues to the U.S. Court of Appeals for the 8th Circuit for further consideration.

On November 5, 1999, the Federal Communications Commission issued an order establishing the network elements that must be offered by incumbent local exchange carriers as unbundled network elements. The Federal Communications

Commission required that most, but not all, of the network elements specified in its initial order, as well as some new network elements not included on the original list, be made available by incumbent local exchange carriers. The Federal Communications Commission also changed the obligation of incumbent local exchange carriers to provide certain combinations of network elements. Various parties have sought reconsideration and filed appeals of the Federal Communications Commission's order. Those appeals and petitions are pending and there can be no assurance as to their ultimate outcome.

On July 18, 2000, the U.S. Court of Appeals for the 8th Circuit issued a decision in which it upheld the Federal Communication Commission's use of a forward-looking methodology to establish prices for network elements, but the Court vacated the agency's rule that the methodology applied should be based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration. Rather, the Court held that the methodology must be applied based on the costs of the incumbent local exchange carriers' existing facilities and equipment. The issue was remanded to the Federal Communications Commission for further consideration. The Court's ruling is currently under review by the U.S. Supreme Court. A decision by the Supreme Court is expected in the Court's fall 2001 term. We are unable to provide assurances as to the outcome of the Supreme Court case or of the remand proceeding that must be conducted by the Federal Communications Commission.

The 8th Circuit also affirmed its prior decision to vacate the Federal Communications Commission rule that required incumbent local exchange carriers to provide combinations of network elements that are not ordinarily combined in their networks. The Court's decision keeps in place the system whereby carriers cannot obtain network element combinations unless the incumbent local exchange carrier has already combined the elements in its network today. The Supreme Court is currently reviewing this issue as well as the pricing issue described above.

WE MUST COMPLETE THE INSTALLATION OF OUR CUSTOMER SERVICE SYSTEMS

Sophisticated information and processing systems are vital to our growth and our ability to monitor costs, bill customers, provision customer orders and achieve operating efficiencies. Initially, our billing and information systems were designed largely in-house with partial reliance on third-party vendors. These systems generally met our needs due in part to our low volume of bills and orders. As we have expanded our services and our customer base, the need for sophisticated billing and information systems has increased significantly. We have embarked upon a program to implement a full suite of order management, customer service, billing and financial applications. These applications include electronic order tracking software developed by Eftia OSS Solutions Inc., providing comprehensive billing functions developed by Billing Concepts Systems, Inc./APTIS, Inc. and financial software developed by PeopleSoft, Inc. The installation of the operational support systems has been substantially completed with development and expansion to continue as needed. The initial installation of the new billing and financial systems was completed during the second quarter of 1999. Additional development of the billing and financial systems will be phased in over time as needed. Our failure to:

- implement the new operational support systems on a timely basis,
- adequately identify all of our information and processing needs, or
- upgrade our systems as necessary,

could have a material adverse effect on our business.

THERE ARE RISKS IN PROVIDING LONG DISTANCE SERVICES

We enter into wholesale agreements with long distance carriers to provide us with long distance transmission capacity. These agreements typically provide for the resale of long distance services on a per minute basis (some with minimum volume commitments or volume discounts). The negotiation of these agreements involves estimates of future supply and demand for long distance telecommunications transmission capacity, as well as estimates of the calling pattern and traffic levels of our future long distance customers. Should we fail to meet our minimum volume commitments, if any, pursuant to these agreements, we may be obligated to pay underutilization charges or we may lose the benefit of

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all or a portion of the volume discounts we have negotiated. Likewise, we may underestimate our need for long distance facilities and therefore be required to obtain the necessary transmission capacity in "spot markets" which are often more expensive than longer term contracts. We cannot assure you that we will acquire long distance capacity on favorable terms or that we can accurately predict long distance prices and volumes so that we can generate favorable gross margins from our long distance business.

WE ARE SUBJECT TO SIGNIFICANT GOVERNMENT REGULATION WHICH MAY CHANGE IN AN ADVERSE MANNER

Our networks and the provision of switched and private line services are subject to significant regulation at the federal, state and local levels. The telecommunications industry in general, and the competitive local exchange carrier industry in particular, are undergoing substantial regulatory change and uncertainty. We cannot assure you that future regulatory, judicial or legislative changes, or other regulatory activities, will not have a material adverse effect on our business. For a further discussion of regulatory issues see Item 1 - "Business--Regulation" of this Report on Form 10-K.

WE WILL BE DEPENDENT UPON KNT NETWORK TECHNOLOGIES LLC FOR OUTSIDE NETWORK RELATED CONSTRUCTION AND MAINTENANCE SERVICES

We are currently in negotiations to complete the transfer of our construction division to KNT Network Technologies, LLC, a company independently owned by Harold N. Kamine and Nassau Capital, our principal stockholders. Pursuant to an arrangement between the parties, effective June 1, 2000, we transferred substantially all of the employees of our construction division to KNT. KNT is providing construction and maintenance services to us and is being reimbursed for all of the direct costs of these activities. In addition, we are currently funding substantially all of KNT's general overhead and administrative costs at an amount not to exceed $15 million per annum. We will be dependent upon KNT for performance of our network related construction needs.

WE ARE DEPENDENT ON AGREEMENTS WITH THIRD PARTIES FOR OUR RIGHTS-OF-WAY AND FRANCHISES

We must obtain easements, rights-of-way, entry to premises, franchises and licenses from various private parties, actual and potential competitors and state and local governments in order to construct and operate our networks, some of which may be terminated upon 30 or 60 days' notice to us. We cannot assure you that we will obtain rights-of-way and franchise agreements on acceptable terms or that current or potential competitors will not obtain similar rights-of-way and franchise agreements that will allow them to compete against us. If any of our existing franchise or license agreements were terminated or not renewed and we were forced to remove our fiber optic cables or abandon our networks in place, such termination could have a material adverse effect on our business. Our agreements for rights-of-way and similar matters generally require us to indemnify the party providing such rights. Such indemnities could make us liable for actions (including negligence of the other party).

THE TELECOMMUNICATIONS INDUSTRY IS SUBJECT TO RAPID TECHNOLOGICAL CHANGE

The telecommunications industry is subject to rapid and significant changes in technology, and we must rely on third parties for the development of and access to new technology. We cannot predict the effect of technological changes on our business. For example, Voice over Internet Protocol technology is not currently being used to any material extent for many of the purposes for which we believe it will in the future. There may be significant obstacles in implementing Voice over Internet Protocol for these purposes. We believe our future success will depend, in part, on our ability to anticipate or adapt to these changes and to offer, on a timely basis, services that meet customer demands. In particular, service offerings in the data transmission sector of the industry are expanding rapidly. We may not be able to anticipate or adapt to such changes and to offer, on a timely basis, services that meet customers' demands.

THE FUTURE SUCCESS OF OUR BUSINESS DEPENDS UPON KEY PERSONNEL

We believe that the efforts of a number of key management and operating personnel will largely determine our success and the loss of any of such persons could adversely affect us. We do not maintain so-called "key man" insurance on any of our personnel. We have employment agreements with Mr. Lenahan, our Chief Executive Officer, Mr. Young, our President and Chief Operating Officer, and Mr. Stewart, our Chief Financial Officer, which expire at various times from March

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2003 through April 2005. Our success will also depend in part upon our ability to hire and retain highly skilled and qualified operating, marketing, financial and technical personnel. The competition for qualified personnel in the telecommunications industry is intense and, accordingly, we may not be able to hire or retain necessary personnel.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Market risks relating to our operations result primarily from changes in interest rates. A substantial portion of our long-term debt bears interest at a fixed rate. However, the fair market value of the fixed rate debt is sensitive to changes in interest rates. We are subject to the risk that market interest rates will decline and the interest expense due under the fixed rate debt will exceed the amounts due based on current market rates. We have entered into two interest rate swap agreements with commercial banks to reduce the impact of changes in interest rates on a portion of our outstanding variable rate debt. The agreements effectively fix the interest rate on $415.0 million of our outstanding variable rate borrowings under our amended senior secured credit facility due 2007. A $325.0 million interest rate swap agreement entered into in April 2000 terminates in April 2004 and a $90.0 million interest rate swap agreement entered into in June 2000 terminates in June 2005. For other information regarding the swap agreements, see Note 6, "Interest Rate Swap Agreements," of the Notes to Consolidated Financial Statements included in Item 8 of this Report on Form 10-K.

The following table provides information about our significant financial instruments that are sensitive to changes in interest rates (in millions):

	Fair Value on December 31, 2000	Future Principal Payments						Total
		2001	2002	2003	2004	2005	Thereafter	
Long-Term Debt:								
Fixed Rate:								
Senior Discount Notes, interest payable at 12 1/2%, maturing 2008	$ 85.3	$ -	$ -	$ -	$ -	$ -	$ 340.2	$ 340.2
Senior Notes, interest payable at 13 1/2%, maturing 2009	109.5	-	-	-	-	-	275.0	275.0
Variable rate:								
Amended Senior Secured Credit Facility, interest variable (11.87% at December 31, 2000)(a)	618.2	-	.6	54.5	99.9	136.5	326.7	618.2
Internet Infrastructure Equipment Financing (8.75% at December 31, 2000)(a)	110.0	18.3	31.4	31.4	28.9	-	-	110.0
Interest rate swaps:								
Variable rate for fixed rate	(13.2)	-	-	-	-	-	-	-
Total	$ 909.8	$ 18.3	$ 32.0	$ 85.9	$ 128.8	$ 136.5	$ 941.9	$ 1,343.4

(a) Interest is based on a variable rate, which at our option, is determined by either a base rate or LIBOR, plus, in each case, a specified margin.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

The following statements are filed as part of this Annual Report on Form 10-K:

FORM 10-K PAGE NO.

REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Stockholders
KMC Telecom Holdings, Inc.

We have audited the consolidated balance sheets of KMC Telecom Holdings, Inc. as of December 31, 1999 and 2000, and the related consolidated statements of operations, redeemable equity, nonredeemable equity and cash flows for each of the three years in the period ended December 31, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of KMC Telecom Holdings, Inc. as of December 31, 1999 and 2000, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.

/s/ ERNST & YOUNG LLP

MetroPark, New Jersey
April 17, 2001

KMC TELECOM HOLDINGS, INC.
CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

	DECEMBER 31 1999	DECEMBER 31 2000
ASSETS		
Current assets:		
Cash and cash equivalents	$ 85,966	$ 109,977
Restricted investments	37,125	37,125
Accounts receivable, net of allowance for doubtful accounts of $5,551 and $10,921 in 1999 and 2000, respectively	27,373	47,141
Prepaid expenses and other current assets	1,375	14,888
Total current assets	151,839	209,131
Long-term restricted investments	51,446	62,931
Networks, property and equipment, net	639,324	1,021,684
Intangible assets, net	3,602	3,835
Deferred financing costs, net	38,816	32,766
Other assets	1,013	928
	$ 886,040	$ 1,331,275
LIABILITIES, REDEEMABLE AND NONREDEEMABLE EQUITY (DEFICIENCY)		
Current liabilities:		
Accounts payable	$ 167,490	$ 180,803
Accrued expenses	37,047	73,605
Deferred revenue	4,309	17,839
Total current liabilities	208,846	272,247
Notes payable	235,000	728,173
Senior notes payable	275,000	275,000
Senior discount notes payable	301,137	340,181
Total liabilities	1,019,983	1,615,601
Commitments and contingencies		
Redeemable equity:		
Senior redeemable, exchangeable, PIK preferred stock, par value $.01 per share; authorized: 630 shares in 1999 and 2000; shares issued and outstanding:		
Series E, 65 shares in 1999 and 75 shares in 2000 ($74,954 liquidation preference)	50,770	61,992
Series F, 44 shares in 1999 and 48 shares in 2000 ($47,866 liquidation preference)	41,370	50,568
Redeemable cumulative convertible preferred stock, par value $.01 per share; 499 shares authorized; shares issued and outstanding:		
Series A, 124 shares in 1999 and 2000 ($12,380 liquidation preference)	71,349	109,272

	1999	2000
Series C, 175 shares in 1999 and 2000 ($17,500 liquidation preference)	40,301	72,701
Redeemable cumulative convertible preferred stock, par value $.01 per share; 2,500 shares authorized; shares issued and outstanding:		
Series G-1, -0- shares in 1999 and 59 shares in 2000 ($19,900 liquidation preference)	-	19,435
Series G-2, -0- shares in 1999 and 481 shares in 2000 ($162,600 liquidation preference)	-	158,797
Redeemable common stock, shares issued and outstanding, 224 in 1999 and 2000	33,755	45,563
Redeemable common stock warrants	12,925	16,817
Total redeemable equity	250,470	535,145
Nonredeemable equity (deficiency):		
Common stock, par value $.01 per share; 4,250 shares authorized, issued and outstanding, 629 shares in 1999 and 637 shares in 2000	6	6
Unearned compensation	(9,163)	(16,608)
Accumulated deficit	(375,256)	(802,869)
Total nonredeemable equity (deficiency)	(384,413)	(819,471)
	$ 886,040	$ 1,331,275

SEE ACCOMPANYING NOTES.

KMC TELECOM HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	YEAR ENDED DECEMBER 31		
	1998	1999	2000
Revenue	$ 22,425	$ 64,313	$ 209,195
Operating expenses:			
Network operating costs:			
Non-cash stock option compensation expense	566	2,387	2,731
Other network operating costs	27,699	81,678	169,593
Selling, general and administrative:			
Non-cash stock option compensation expense	6,514	27,446	31,840
Other selling, general and administrative	34,171	84,434	162,275
Depreciation and amortization	9,257	29,077	76,129
Total operating expenses	78,207	225,022	442,568
Loss from operations	(55,782)	(160,709)	(233,373)
Other expense	--	(4,297)	--
Interest income	8,818	8,701	11,784
Interest expense	(29,789)	(69,411)	(136,393)
Net loss before cumulative effect of change in accounting principle	(76,753)	(225,716)	(357,982)
Cumulative effect of change in accounting principle	--	--	(1,705)
Net loss	(76,753)	(225,716)	(359,687)
Dividends and accretion on redeemable preferred stock	(18,285)	(81,633)	(94,440)
Net loss applicable to common shareholders	$ (95,038)	$ (307,349)	$ (454,127)
Net loss per common share before cumulative effect of change in accounting principle	$ (114.42)	$ (360.88)	$ (529.22)
Cumulative effect of change in accounting principle	--	--	(1.99)
Net loss per common share	$ (114.42)	$ (360.88)	$ (531.21)
Pro forma amounts assuming the change in accounting principle was applied retroactively:			
Net loss applicable to common shareholders	$ (95,424)	$ (309,054)	$ (452,422)
Net loss per common share	$ (114.88)	$ (362.88)	$ (529.22)
Weighted average number of common shares outstanding	831	852	855

SEE ACCOMPANYING NOTES.

KMC TELECOM HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF REDEEMABLE EQUITY
YEARS ENDED DECEMBER 31, 1998, 1999 AND 2000
(IN THOUSANDS)

	REDEEMABLE EQUITY									
	Preferred Stock									
	Series A		Series C		Series D		Series E		Series F	
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount
BALANCE, DECEMBER 31, 1997	124	$ 18,879	150	$ 14,667	25	$2,379	--	$ --	--	$ --
Conversion of Series D Preferred Stock to Series C Preferred Stock.....			25	2,379	(25)	(2,379)				
Issuance of common stock.............										
Accretion of redeemable equity........		11,511		4,597						
Payment of dividends on preferred stock of subsidiary..................										
Issuance of warrants..................										
Cancellation of KMC Telecom stock options..............................										
Issuance and adjustments to fair value of stock options to employees...										
Issuance and adjustments to fair value of stock options to non-employees..................										
Amortizations of unearned compensation.......................										
Net loss..............................										
BALANCE, DECEMBER 31, 1998	124	30,390	175	21,643	--	--	--	--	--	--
Issuance of Series E Preferred Stock...							60	44,829		
Issuance of Series F Preferred Stock...									40	34,817
Stock Dividends of Series E Preferred Stock..................................							5	5,004		
Stock Dividends of Series F Preferred Stock..................................									4	4,177
Issuance of warrants..................										
Reclassification of warrants related to "put rights"....................										
Exercise of warrants..................										
Accretion on redeemable equity.........		40,959		18,658				937		2,376
Issuance and adjustments to fair value of stock options to employees.......................										
Adjustment to fair value of stock options to non-employees............										
Amortization of unearned compensation..										
Exercise of stock options.............										
Reclassification of additional paid-in capital deficiency............										
Net loss..............................										
BALANCE, DECEMBER 31, 1999	124	71,349	175	40,301	--	--	65	50,770	44	41,370
Issuance of Series G1 Preferred Stock..										
Issuance of Series G2 Preferred Stock..										
Stock Dividends of Series E Preferred Stock..................................							10	9,951		
Stock Dividends of Series F Preferred Stock..................................									8	6,654
Accretion on redeemable equity.........		37,923		32,400				1,271		5,509
Issuance and adjustments to fair value of stock options to employees....										
Issuance and adjustments to fair value of stock options to non-employees....................										
Exercise of stock options.............										
Amortization of unearned compensation..										
Redemption and retirement of Series F Preferred Stock.....................									(4)	(2,965)
Reclassification of additional paid-in capital deficiency.................										
Net loss..............................										
BALANCE, DECEMBER 31, 2000	124	$109,272	175	$72,701	--	$ --	75	$61,992	48	$50,568

KMC TELECOM HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF REDEEMABLE EQUITY
YEARS ENDED DECEMBER 31, 1998, 1999 AND 2000
(IN THOUSANDS)

	REDEEMABLE EQUITY					
	Preferred Stock					
	Series G		Common Stock			
	Shares	Amount	Shares	Amount	Warrants	Total Redeemable Equity
BALANCE, DECEMBER 31, 1997	--	$ --	133	$11,187	$ 539	$ 47,651
Conversion of Series D Preferred Stock to Series C Preferred Stock....						
Issuance of common stock..............						
Accretion of redeemable equity.........			91	9,500		9,500
Payment of dividends on preferred stock of subsidiary.................				1,618	135	17,861
Issuance of warrants..................						
Cancellation of KMC Telecom stock options............................						
Issuance and adjustments to fair value of stock options to employees....						
Issuance and adjustments to fair value of stock options to non-employees...................						
Amortizations of unearned compensation.......................						
Net loss..............................						
BALANCE, DECEMBER 31, 1998	--	--	224	22,305	674	75,012
Issuance of Series E Preferred Stock...						
Issuance of Series F Preferred Stock...						44,829
Stock Dividends of Series E Preferred Stock...............................						34,817
Stock Dividends of Series F Preferred Stock...............................						5,004
Issuance of warrants..................						4,177
Reclassification of warrants related to "put rights".....................					10,606	10,606
Exercise of warrants..................					(249)	(249)
Accretion on redeemable equity.........						
Issuance and adjustments to fair value of stock options to employees.......................				11,450	1,894	76,274
Adjustment to fair value of stock options to non-employees............						
Amortization of unearned compensation..						
Exercise of stock options.............						
Reclassification of additional paid-in capital deficiency...........						
Net loss..............................						
BALANCE, DECEMBER 31, 1999	--	--	224	33,755	12,925	250,470
Issuance of Series G1 Preferred Stock..						
Issuance of Series G2 Preferred Stock..	59	19,355				19,355
Stock Dividends of Series E Preferred Stock...............................	481	158,145				158,145
Stock Dividends of Series F Preferred Stock...............................						9,951
Accretion on redeemable equity.........						6,654
Issuance and adjustments to fair value of stock options to employees..		732		11,808	3,892	93,535
Issuance and adjustments to fair value of stock options to non-employees...................						--
Exercise of stock options.............						--
Amortization of unearned compensation..						--
Redemption and retirement of Series F Preferred Stock.....................						--
Reclassification of additional paid-in) capital deficiency.................						(2,965)
Net loss..............................						--
						--
BALANCE, DECEMBER 31, 2000	540	$178,232	224	$45,563	$16,817	$535,145

SEE ACCOMPANYING NOTES.